

Asset Management

Portfolio Manager Interview HSBC GIF Euroland Value

September 2023

Article 8* SFDR

Doctrine AMF non compliant

For professional investors as defined by MIFID

Key points

- Valuation and economic performance are the key drivers for the market value of a company.
- Over the past years, markets have disregarded the valuation component: they overpay for beautiful growth stories and underpay for ordinary stories.
- Despite a small rebound recently, the Value theme has barely started to recover. Valuation spreads remain at record highs, whilst Value stocks earnings are resilient.
- Style timing is very difficult if not impossible. Yet a number of signals suggests that the valuation gap has to shrink: we think being underweight “Value” is very risky.
- The European Equities team at HSBC Asset Management has built a recognized expertise in Value investing over the past 19 years, based upon a Relative Value approach and relying on the fundamental analysis of stocks.
- HSBC GIF Euroland Value provides a structural exposure to the Value factor. The fund has significantly outperformed the MSCI EMU since 2004 and ranks well compared to Euroland peers.



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After underperforming for several years, investors have brushed aside Value as key driver of stock returns, what is your view?

Only two variables determine the long-term return of a stock:

- its current valuation,
- and its future economic performance.

This is not a point of view or an opinion, it's an accounting identity.

We can play around with this very simple rule. The most obvious, as stated, is that the return you're going to earn from your equity investment depends on the price you pay for that investment and the future economic performance of the business you invested in. But you can see it the other way around:

- current valuation is a reflection of the return you are requiring for your investment (based on how risky the business is),
- or a reflection of a company's future profits.

Our research shows that valuation doesn't reflect future earnings growth very well.

This simple rule also suggests that you can invest in a company embedding great economic performance, but the stock will be a poor financial investment, given its valuation.

Economic performance doesn't necessarily translate into financial performance. There are many examples in history that prove this. Likewise, you can invest in a company with lackluster growth that will turn out to be a great financial investment. There is a saying: "a great company can be a boring stock and a boring company can be a great stock".

Here are a couple of examples.

End of the sixties, early seventies have been called the Nifty-Fifty era: 50 US companies (Coca-Cola, General Electric, IBM, McDonald's, Pfizer...) massively outgrew the rest of the economy for more than a decade and yet crashed in 1973, underperforming for the next decade.

The internet bubble: sure, internet has definitely changed the world but investing in Tech at the end of the 90's resulted in a massive disappointment. If you had bought the US Tech sector in mid-1999, you would still be losing money on your investment 14 years later. Yet Tech profits, over the same period, grew by almost 9% per annum which is almost twice the average growth rate of US profits.

Over that same period, if you had invested your money in boring US consumer staples, you would have almost tripled your investment (+165%) thanks to valuation and dividends! Yet profits for consumer staples grew roughly at the same rate as US profits in general.

Sure, buying growth stories can make sense as long as the price you pay for these stories doesn't imply unrealistic massive profit growth for the next 10 years, the typical investment horizon over which investors value equities. Our research suggests forecasting future long term growth is very difficult and companies with a true growth status are quite rare. Over 15 years, only 2.5% of European companies are able to grow by more than 20% per annum, 6% are able to grow by more than 15% per annum. Over 10 years, 13% of European companies are able to grow by more than 20% per annum, 23% are able to grow by more than 15% per annum.

We think that today there is an anomaly in the way the market prices growth. It overpays for beautiful stories and underpays for ordinary stories.

I was asked if AI (Artificial Intelligence) is a fad or a true structural change in our societies. Remember the internet bubble: this is the not right question for defining an investment strategy. I answered it is probably a structural change but given current valuations I wouldn't necessarily be buying AI companies.

If valuation is so important, how come Value stocks have underperformed over the past 15 years?

Let's go back to the burst of the internet bubble. At that time, in 2000, Growth stock valuations were extreme relative to Value stocks. This created a multi-year rally in Value stocks up until 2007. When the Great Financial Crisis started, the valuation of Value and Growth stocks converged, and Value. Besides Value earnings were inflated by excess financial leverage. The GFC is the burst of the Value bubble and lasted roughly up until 2012.

Until 2018, Value's underperformance followed a logical historical pattern. During particularly adverse periods for Value such as the euro crisis, the deflationary environment or the China bubble, the relative earnings growth of Value stocks generally worsened making their valuations less attractive relative to Growth stocks. As a result, investors switched into less cyclical high quality stocks.

The performance figures displayed in the document relate to the past and past performance should not be seen as an indication of future returns.

Source: HSBC Asset Management, as of end of August 2023

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However, around 2018, the valuation spread continued to widen way beyond its long-term historical range (see figure below).

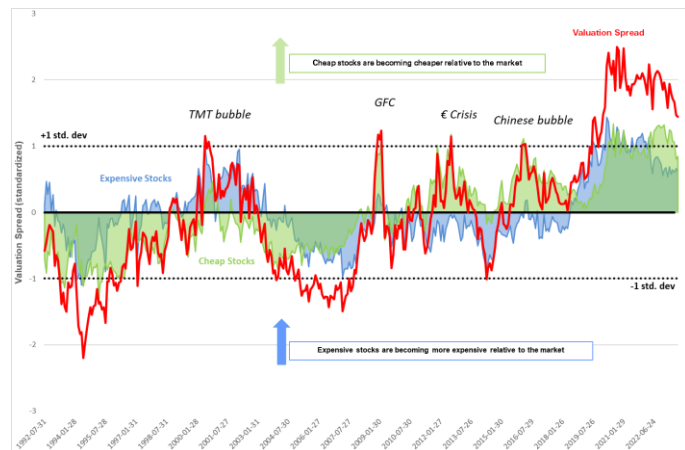
We can see a couple of reasons that could justify this trend:

- A form of capitulation on Value due to a succession of crises in Europe which has structurally increased the price of risk and uncertainty (the so called risk premium),
- The impact of interest rates on the relative returns between Value and Growth.

Although uncertainty is a sensible argument, we find it difficult to justify the record valuation gap between Value and Growth. In fact, the current valuation spread suggests that investors are overly complacent about Growth stocks' future economic performances (they are more cyclical than you think) and irrationally fearful of Value stocks, some of which are priced as if they were going to fail.

Regarding the impact of interest rates on equity valuations and the whole "long duration vs. short duration debate", simulations suggest that the impact of falling interest rates on equity valuations is significantly less than what has been observed by a scale of 1 to 3. The interest rate argument has been largely used as interest rates were falling but surprisingly became less relevant when interest rates started to rise.

Fig. 1: Europe Value Spread (Price to book: expensive vs. cheapest) - Period: July 1992 to August 2023



Source: HSBC Asset Management, Morgan Stanley, MSCI as at 31/08/2023. For illustrative purposes only.

Why is value attractive today?

Despite a small rebound recently, Value has barely started to recover. Valuation spreads remain at record highs. Investors have been getting out of Value on the back of recessionary risks. It is true that Value earnings have been more cyclical over the past 15 years; but currently Value earnings are holding up surprisingly well. The banking sector (the Value sector "par excellence") is growing its earnings by 30% on a Year-on-Year basis yet the market is expecting bank earnings to fall by 30% in the next 12 months (if valuations are a good indication of future growth...).

Other signs show some equity markets are bubbly. The US market's valuation relative to Europe has never been this high, yet US earnings are lagging European earnings. The US market has never been as concentrated. The 10 biggest market caps (most of which belong to the Tech sector) represent more than 30% of the SP 500; this is more than the 25% reached at the peak of the internet bubble and more than the historical average of 17%. The 10 biggest market caps trade at 47X next-twelve-month earnings on average.

Finally, we are starting to see cracks in the Growth canvas. Adyen, the leading provider of on-line payment solutions, disappointed the investment community by reporting quarterly earnings slightly below the consensus estimates (-3.6%), and yet the stock plunged by 50% on that news. Richemont's chairman warned that inflation in Europe is starting to weigh on demand, reminding investors that luxury companies are not immune to the economic cycle. Moreover, the richly valued semiconductor equipment makers suffered from a report that TSMC, the leading chip manufacturer, announced it was delaying orders as demand was softening.

Style timing is very difficult if not impossible. Yet a number of signals suggests there is a valuation anomaly. We think being underweight Value (and as a consequence being overweight Growth) is very risky.

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Source: HSBC Asset Management and MSCI as of end of August 2023

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How to get exposure to Value in the Eurozone?

The universe of Eurozone Large Cap Equities as defined by Morningstar is made up of 160 funds. We analyzed each of these funds and measured their sensitivities to Value as well as the Alpha they are able to generate, i.e. the funds' excess return that is not explained by Value or other well known factors (Size, Quality, SRI).

Over 5, 3 and 1 years, on average, only 25% of the universe has a true Value bias. 30% of the universe has a true Growth bias but the average sensitivity to Growth is much more important than the average sensitivity to Value.

When looking at the Value sample, HSBC GIF Euroland Value has always ranked in the top 10 in terms of sensitivity to Value.

When measuring the Alpha, HSBC GIF Euroland Value has consistently been in the top five. No other fund has been able to hold that rank over 1, 3 and 5 years.

In terms of other factor characteristics, it is slightly negatively correlated to Quality and neutral to the Market and SRI factors. Its higher sensitivity to the Size factor results from the market's overweighting in mega cap Growth stocks.

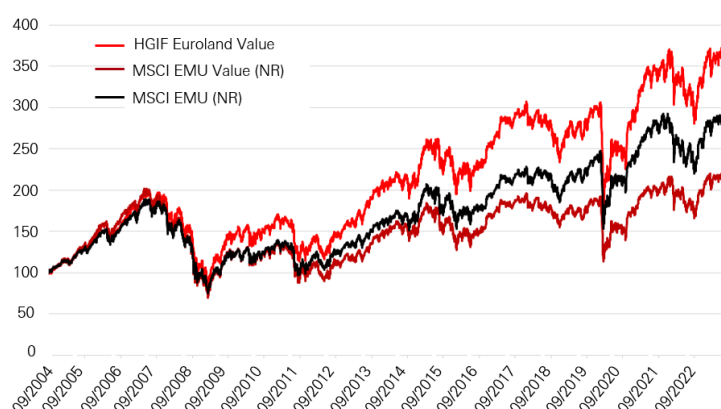
Our fund is very well diversified sectorally. This is due to the fact that our approach considers relative Value, i.e. we can invest in names whose valuation is high in absolute terms, if that is justified by their structural profitability. As a consequence, it does not take outsized bets in traditional Value sectors such as Financials, Materials, Utilities, Energy and Communications. Instead, it seeks to identify Value across a wide range of sectors.

Strong Alpha generation has allowed us to outperform the MSCI EMU NR index by 94.8% gross of fees¹. Its outperformance against the MSCI EMU Value index is equally impressive.

Finally, the European Equities Team at HSBC Global Asset Management has built a true expertise in terms of Value investing over the past 19 years.

Our "Profitability/Valuation" philosophy is a simple, theoretically sound approach to identify stocks with the highest expected returns. The stock selection process relies upon the fundamental analysis of companies. It has been stable over time and implemented by experienced investment professionals (over 20-year average market experience).

Fig. 2: Value strategy – Track record since launch² (gross of fees)



Source: HSBC Asset Management, MSCI as at 31/08/2023. For illustrative purposes only.

Performance (gross of fees)

	HSBC GIF Euroland Value	MSCI EMU (NR)	Excess Return
30/09/2004–31/12/2004	7.77%	8.61%	-0.84%
2005	29.78%	25.37%	4.41%
2006	21.88%	21.92%	-0.04%
2007	11.34%	7.88%	3.46%
2008	-43.24%	-44.85%	1.61%
2009	38.26%	27.25%	11.01%
2010	2.91%	2.40%	0.51%
2011	-16.91%	-14.89%	-2.02%
2012	19.57%	19.31%	0.26%
2013	32.91%	23.36%	9.55%
2014	3.84%	4.32%	-0.48%
2015	12.88%	9.82%	3.06%
2016	5.79%	4.33%	1.46%
2017	15.05%	12.63%	2.42%
2018	-17.13%	-12.75%	-4.38%
2019	23.60%	25.45%	-1.85%
2020	-5.29%	-1.00%	-4.29%
2021	24.79%	22.14%	2.65%
2022	-6.22%	-12.47%	6.25%
YTD as of 31/08/2023	15.46%	13.88%	1.57%

Source: HSBC Asset Management, MSCI as at 31/08/2023. For illustrative purposes only.

Main risks: capital loss risk, discretionary management, equity risk.

1. From end September 2004 to end August 2023

2. Since September 2004, the fund has been managed following the profitability and valuation investment process.

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Source: HSBC Asset Management, Morningstar as of end of August 2023

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What environmental and/or social characteristics are promoted by this financial product?	<p>The sub-fund includes the analysis of a company's environmental and social factors, including but not limited to physical risks of climate change and human capital management. This analysis is an integral part of the investment decision making process. In addition, HSB CAsset Management also considers corporate governance practices that protect minority investor interests and promote long term sustainable value creation.</p> <p>The reference benchmark for sub-fund market comparison purposes is MS C EMU, however, this is not designated for the purpose of attaining the environmental or social characteristics promoted by the sub-fund.</p>
Binding commitment	<ul style="list-style-type: none"> - The sub-fund aims to have a higher ESG score, than the ESG score of the reference index. - Exclusions
Exclusions	<p>The sub-fund will not invest in equities and equity equivalent securities of companies that are considered non-compliant with the United Nations Global Compact (UNG C Principles. The sub-fund conducts enhanced due diligence on companies that are considered to be non-compliant with the UN Global Compact Principles, or are considered to be high risk as determined by the HSB Cs proprietary ESG ratings.</p> <p>Excluded Activities and specified involvement are proprietary to HSB Cand include, but are not limited to:</p> <ul style="list-style-type: none"> • Companies involved in the production of controversial weapons or their key components. Controversial weapons include but are not limited to anti-personnel mines, depleted uranium weapons and white phosphorous when used for military purposes. This exclusion is in addition to HSB C's banned weapons policy which is available at: www.assetmanagement.hsbc.com/about-us/responsible-investing/policies • Companies involved in the production of tobacco. • Companies with more than 10% revenue generated from thermal coal extraction and do not have a clearly defined, credible plan to reduce exposure to below 10%. • Companies with more than 10% revenue generated from coal-fired power generation and do not have a clearly defined, credible plan to reduce exposure to below 10%.
Principle Adverse Indicators	<ul style="list-style-type: none"> • Green house gas intensity of investee companies - Scope 1 & Scope 2 • Violation of UNGC and OECD principles • Board gender diversity • Share of investment involved in controversial weapons
Min E/S	na
Min Sustainable Investing	10%
Taxonomy	na

Source: HSBC Asset Management

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